

John Gieve: Economic prospects and the policy challenge

Speech by Sir John Gieve, Deputy Governor of the Bank of England, at the Cityco Breakfast Meeting, Manchester, 16 January 2009.

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Introduction

One of the things that strikes me most on coming back to Manchester is the pace at which the fabric of the city changes – and I was looking at this yesterday from up on the 23rd floor. It's not much more than two years since I was last here but in that time the city centre has added about half a million square feet of retail space, more than 1½ million sq ft of new office space and nearly 8000 extra hotel beds (a 40% increase).

All this development reflects the attractiveness of Manchester as a location for inward investment and even more importantly the strong growth in businesses indigenous to the city, many of which are represented today. But while I gather that nearly a million square feet of office space has been let again in 2008 it is clear that in Manchester, as elsewhere, the past year has been increasingly challenging for businesses of all types and the prospect is forbidding.

The severity and nature of the challenges we face particularly in the banking sector makes it very difficult to predict where we will be in a year from now. And the pace of change means that it is even more true today than usual that we cannot rely for navigation on official statistics alone. So as members of the Monetary Policy Committee we see it as more important than ever to make visits such as this so that we can talk to businesses face to face about the conditions they are experiencing on the ground. And every month our Agents in the regions, including the North West, give us a comprehensive report based on a large number of meetings with contacts in all sectors of the economy.

2009 is certain to be a difficult year for the UK and the global economy more generally. In the United Kingdom, we expect the sharpest fall in output for decades while on some measures, retail prices are likely to fall for the first time in almost half a century. We are not alone in our difficulties. Most of our major trading partners are also entering recession. A decade or more of remarkable macroeconomic stability; *the Great Stability* as economists called it, has come to a shuddering halt.

These exceptional developments have led already to exceptional policy measures. Here in the United Kingdom, the government has set in train a fiscal expansion and has stepped in to support the banking system and lending. And earlier this month, we reduced official interest rates to an historic low of 1.5%. Similar measures have been taken overseas.

My purpose today is to explain how this recession differs from the others I have lived through, why that calls for a wider range of responses than normal, and the difference between the policy objectives in the medium term and the short term.

The boom before the bust?

What is striking about the run-up to this recession is that we did not see the booms in output, employment and wages that led to past recessions. Past recessions, in good measure, reflected deliberate decisions by policymakers to rein in spending and damp the inflationary pressures that had been building up. The rise in interest rates then led to a correction in the spending behaviour of households and companies as optimism about future income growth in the boom turned to uncertainty and gloom in the bust.

Chart 1 highlights what was happening to domestic output in the two years before the last three recessions. The *Barber Boom* was a case in point, when output rose by 10% over the

year to 1973 Q1, and then fell by 3% over the following year. You can see a similar pattern before the recessions of the early 80s and early 90s. But in 2006 and early 2007 growth was close to its average over the past 30 years.

That is not the whole story of course. When we look at asset markets, a different story emerges. The credit boom may not have led to a rapid inflation in the price of goods and services, but it did support a surge in the price of a broad range of assets. Property prices soared (**Chart 2**). The price of stocks and bonds also rebounded strongly from their early decade lows.

That rise in prices was driven by and reflected in a sustained rise in borrowing. A combination of factors – including a large flow of savings out of the emerging economies, and a reduction in the return that investors required to bear risk – had allowed the banks to raise large sums of money at a very low price. And, as memories of earlier busts faded, the margin that banks charged their customers over those lower funding costs was also compressed by increased competition.

Households and companies were therefore able to borrow more money at ever more attractive terms. Loan to income ratios crept up. And UK banks became increasingly dependent on borrowing from wholesale investors overseas (**Chart 3**). By the eve of the Credit Crunch in 2007, the balance sheets of the banks and households and some companies to whom they had lent large sums of money had become stretched.

All this looked sustainable so long as banks could continue to get access to cheap funds, and households and companies could rely on a steady stream of income and profit to service debt. But once the music stopped, those leveraged balance sheets were very vulnerable and adjusting them is proving very painful. That process is at the heart of the events unfolding here in the UK and around the world.

But the crisis here was not triggered by rising household defaults or corporate failures in the UK; in fact they have started to rise only recently. The crisis started in the US housing market and spread to the rest of the world through the banking system. And the problems in the US were themselves a reflection of global imbalances in trade and capital flows between advanced and emerging economies. The rapid growth of exports from Asia, and latterly the Gulf, was reflected in a substantial build up of savings which financed a rapid growth of credit in the West.

When losses emerged in US sub-prime market, they ricocheted through the international financial system, including British banks. Not only did they face losses on their portfolios of structured credit but sources of funding on which they had become dependent, particularly securitisation, dried up.

A global economic slowdown

Initially, the impact of the crisis seemed to be concentrated in the US and a handful of European banks while the emerging economies of Asia continued to boom. With wages and prices rising, many of the people I met in India and China this time last year rather welcomed the prospect of a fall in Western demand as a means of taking a little of the heat out of their own economies. But the picture has changed since then.

In the UK we have experienced a sharp and broad-based slowdown in activity that gathered momentum in the autumn (**Chart 4**). In part that reflected the concerted credit squeeze that started in summer 2007. But we also saw a sharp drop in confidence among consumers and companies after the crisis in the banking system which followed the decision to allow Lehman Brothers to fail in September last year.

A similar drop in confidence has been observed across the world – in China and India as much as in the West – and we are now in the throes of a severe and coordinated contraction worldwide (**Chart 5**). Even those countries which sat out the excesses of the credit boom

have been affected by the slowdown. Around the globe, sectors like manufacturing which are heavily dependent on world trade have been particularly badly hit by the ebb tide of global demand. In the United States, the ISM survey of manufacturing activity posted a near thirty year low in December. And in Japan, the November fall in industrial production was the largest percentage contraction on record. The recent industrial production figures from Germany, France and Italy tell a similar story.

The outlook for the remainder of 2009

The immediate prospects in the UK, as elsewhere, remain difficult. Data on new orders suggest that output is likely to fall sharply in the first quarter of 2009 as well as in Q4 of last year; further declines in output, if not at the same pace, are likely beyond then.

The widening margin of spare capacity will act as a significant drag on costs and prices. Coupled with the deflationary impact of falling commodity prices and the cut in VAT, CPI inflation will continue falling over the year and may go well below the target rate of 2% despite the impact of sterling's depreciation on import prices. With its inclusion of mortgage interest and other housing costs, the change in the RPI is expected to turn negative.

The downturn itself has set powerful contractionary forces to work.

Over-indebted households and companies will be pulling back on spending to try and pay down those debts. Although the recent falls in commodity prices will help to mitigate some of the downward pressure on household income, rising unemployment is not only constraining the spending of those losing or not finding jobs but is likely to boost precautionary saving across the household sector. And falling property prices are reducing activity in the housing market and the construction sector.

With credit hard to come by, companies will find it difficult to fund new investment projects and few companies would be likely to invest large sums of money even if they could raise the funds. Commercial property prices are still falling rapidly. More generally, the uncertainty over the depth and duration of the recession discourages investment and puts cash flow at a premium. There is every incentive for companies to batten down the hatches. Unsurprisingly then, investment intentions have fallen sharply (**Chart 6**).

The stock cycle is also depressing output. Stocks initially rise as sales falter and those stocks of inputs, work-in-progress and finished output that companies have become more difficult and expensive to finance. But running stocks down involves sharp cuts in production as we are seeing in the motor industry.

All these forces develop in any recession. The special features of this one are its global reach, so the contraction at home is compounded by falling demand for exports, and the severity of the pressures on the banks many of whose survival has been at risk. They too face funding and capital pressures to shrink their balance sheets even if it means turning away good business. Successive credit surveys show not just a reduction in demand but a growing constraint on supply. Not only have spreads increased but there is clear evidence of quantity rationing in some markets which is compounding the normal contraction in investment and the squeeze on working capital.

I should add that that does not mean that all banks have stopped lending. They have not. As **Chart 7** shows, in the housing market for example there is a clear difference between the biggest UK banks and the rest; we saw a big increase in lending especially by foreign banks in the years 2006 and 2007; many of them have now withdrawn from the market. On top of that, of course Northern Rock and Bradford and Bingley have largely ceased new lending. As a result the continued lending of the main banks – and some smaller banks and building societies – is offset by reductions elsewhere. What matters for the economy as a whole of course is the total flow of credit.

The policy challenge

Nearly all economic policy decisions work with a lag. So there is a limited amount we can do at this point to influence the path of output in the first half of this year (although there may be ways of mitigating the costs). The main challenge now is to prevent a deep recession being unnecessarily prolonged. I want to conclude by making three points about that challenge.

First, the full impact of the measures of the last few months have yet to be felt. In the UK, the Bank has cut interest rates from 5% to 1.5% since October, the government has cut taxes and expanded spending and the banking system has been supported through recapitalisation and improved access to funding and liquidity. These measures will have a growing effect, even if we do nothing more. While the transmission mechanism from official interest rates to the economy has been impaired by the dislocation of financial markets, the cuts in interest rates are still having an impact. While the reductions in the income of savers have offset to some extent the benefits to borrowers in the household sector, the net gain to the company sector is clear.

The changes in interest rates have also accounted in part for the depreciation in the sterling exchange rate, which is down around a fifth in the past six months. No one who has lived through the 70s, 80s and early 90s will be complacent about a fall in sterling. But there is no doubt that an appreciable fall in the pound, such as we have seen, has been helpful both in supporting exports and import substitution in the short term and in encouraging the rebalancing of the economy that we need in the medium term.

My second point is that it is important to distinguish the medium term from the short term goals. In the medium term we need to see a rebalancing of the economy in the UK, and some other countries, with a higher savings rates, less leverage in the financial sector, and higher net exports. However if everyone tries to increase saving and cut borrowing immediately we could prolong the downturn painfully. If everyone plans for the worst, we are more likely to get it. That is why economists sometimes sound a bit like St Augustine who famously noted in his confessions *"Make me chaste and continent, but not yet"*.

This apparent tension between the medium term and the short term is evident in the banking sector. One lesson of the last 18 months has been that in the medium term banks need to work with lower leverage and higher buffers of capital and liquidity. I have argued elsewhere that we need in future to relate these buffers to the state of the economic and financial cycle so that they expand in good times and are sufficient to cover the inevitable losses in bad times. In a sense the purpose of the recapitalisation in October was to put banks capital up to the level it should have been had such counter cyclical measures been in place. But, at the moment we are in the downswing and we need to allow the banks to use those cushions and reduce their capital ratios from the new and higher starting point.

The third point I want to make is about the breadth of the policy response. Long experience has shown that interest rates are the most powerful and effective instrument for managing the economy. As a result other regulatory and fiscal measures have taken a back seat in macroeconomic management in the last 15 years.

However the distinguishing feature of this recession is that it is centred on the banking system, which is at the heart of the allocation of resources through the economy and of the transmission mechanism for monetary policy. It is no surprise therefore that both in this country and elsewhere interest rates have been supplemented by measures that have directly focussed on banking and financial markets.

Credit is a critical lubricant in a modern economy. It can bridge the gap between expenditure and income. It supports investment: allowing households and companies to bring forward the purchase of expensive assets, which would otherwise require an extended period of saving. And it allows spending to be smoothed in the face of unexpected shocks to income.

As credit became more scarce, the economy was bound to slow, amplifying the slowdown in the real economy that was already in train. A feedback loop started to gather momentum.

The more the banks reined in lending, the worse the economic outlook became, and the greater spectre of rising credit losses on the banks' loan portfolios, encouraging further cuts in lending.

Policymakers had to intervene to cut this feedback, to prevent funding markets for banks and industry from freezing up, and to ensure that the banks have the capital, the funds and the confidence to continue lending.

The measures taken in October were successful in preventing a systemic collapse and in the first week of the New Year there were some signs of a more general easing of pressures in financial markets. However there have been many relapses in the last 18 months and yesterday we again saw renewed fears in the markets.

On the policy side, it is worth remembering that it is possible to overdo the degree of support. But at present the risks remain clearly to the down side. Therefore, in setting policy, the authorities both here and overseas need to consider whether further action on interest rates (or other monetary measures) or fiscal action is required. They need also to consider whether to do more to underpin the confidence among banks and among investors that is necessary to support the lending the economy needs to emerge from recession.

Chart 1: Annual GDP growth

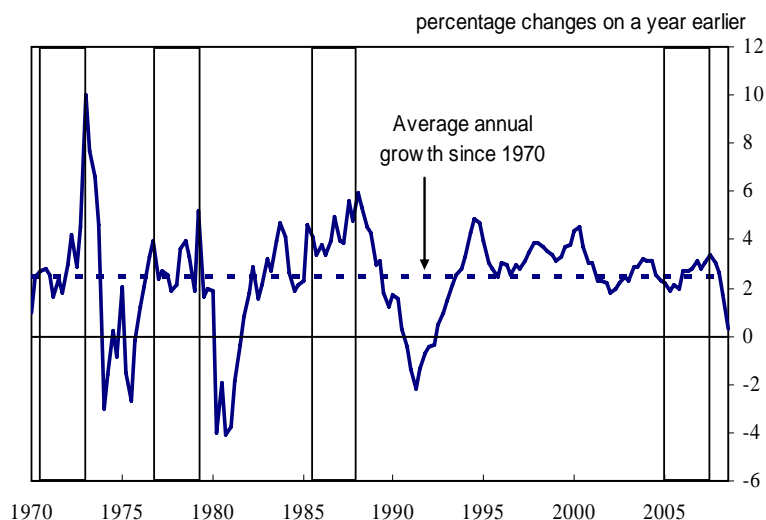


Chart 2: Property prices

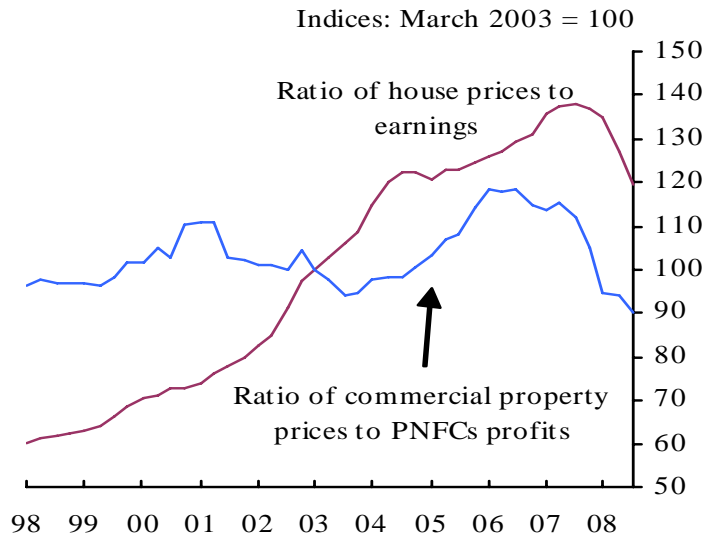


Chart 3: Customer funding gap

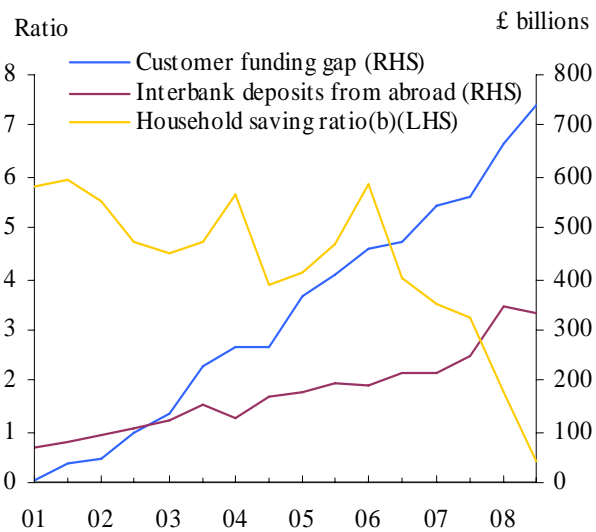


Chart 4: Survey measures of activity

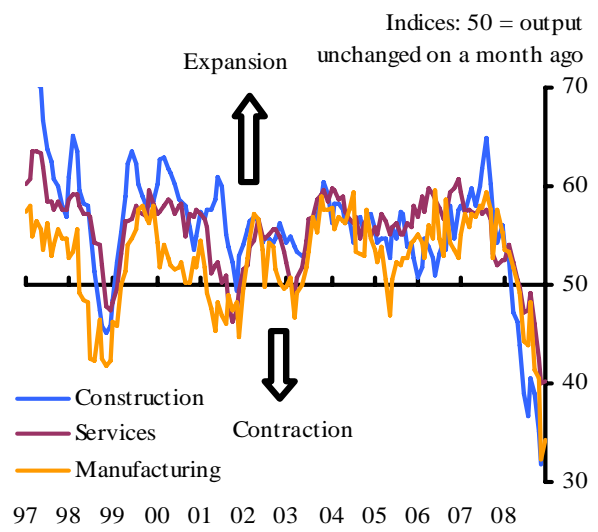


Chart 5: Global output

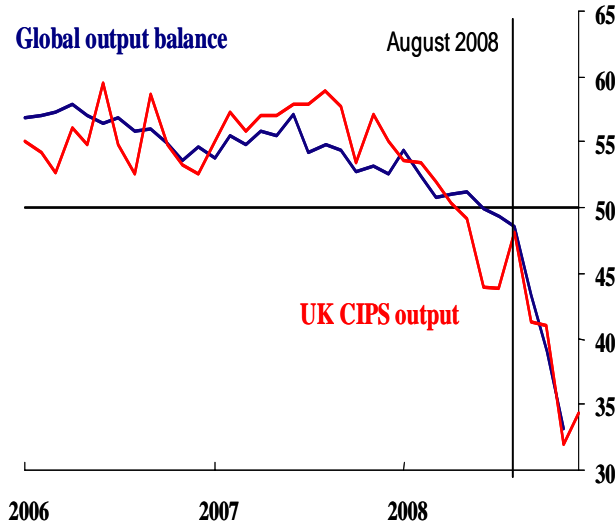


Chart 6: Investment intentions

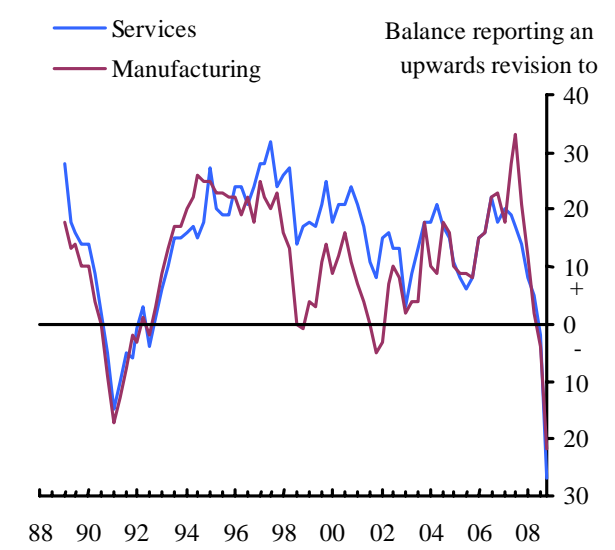


Chart 7: Growth in secured lending

